NEWS DISSEMINATION AND THE EU TRANSPARENCY DIRECTIVE

Position Paper by

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PR Newswire
Investor Relations Society
Association of British Insurers
Confederation of British Industry
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Quoted Companies Alliance
National Association of Pension Funds
Association of Private Client Investment Managers and Stockbrokers
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Introduction

Internal Market Commissioner Bolkestein has said that:

> *"A true internal market in financial services needs investors to be able to invest across borders easily and with confidence. I want to achieve that without excessive burdens on issuers.*
>
> *Enlightened companies do not consider transparency as wasted effort, but as an investment in loyalty and trust."*

We agree with the Commissioner and endorse his objectives. But our concern is that the proposed Transparency Directive in its current form won't deliver.

By mandating Quarterly Reports for all public companies, the Commission is favouring a static model of disclosure when we believe continuous disclosure can offer more to investors.

Europe risks missing an opportunity to raise the quality of disclosure across all the Member States and to promote a real pan-European market for investment and for company information.

What is Transparency?

Transparency is key to any efficient market and in financial markets effective disclosure is fundamental.

> **Transparency is not just about "what" information is disclosed, it's also "how" it's disclosed that matters.**

Participants in today's fast-moving financial markets need immediate access to all the available information on a company and the trading in its shares. But managing a portfolio is about the wider sector and particularly companies' major competitors as well as the companies whose equities are specifically included. Conventional economic theory about markets is based on the assumption that markets operate with "perfect" information – ie "everyone knows everything". But that's patently not the case and there is powerful research[1] that shows how damaging these "information asymmetries" can be.

> **In the worst case, exploiting these asymmetries, for example by taking advantage of privileged access to price-sensitive information, is a form of market abuse.**

The Commission rightly sees the Transparency Directive as the vehicle to raise standards of disclosure across the EU. Without higher standards, the EU's ambition of creating single financial services market will remain just that.

> **Integral to the success of the Transparency Directive is improving mechanisms to distribute information – vital if confidence in Europe's equity markets is to grow.**

Unless they are being specifically targeted, company information reaches investors and potential investors in two ways. Either investors find it by searching for it, in newspapers, in company annual, half yearly and quarterly reports or in trading statements, on websites or from analysts' reports. Or it's delivered by means of a system of intermediary news providers. This means that information can be *pushed* real-time out to the market in a form that investors find easier to understand.

[1] Akerlof, Stiglitz and Spence on the "Economics of Information".

Fast, simultaneous and pan-European distribution of price sensitive and other regulatory news will ensure all investors, retail and professional alike, are operating on a level playing field.

For the EU to become a world leader in company disclosure and in the integrity of its equity markets, we need "real-time electronic push distribution" of news.

Instead the Commission is mandating a model that relies more on quarterly reports and the use of company websites as mechanisms for disclosure. Companies make periodic reports for a variety of reasons, commercial as well as regulatory. Regular trading statements are also increasingly used by companies both to give an update on revenues and performance and to comment on market conditions. Indeed this may be a preferred method for communication between companies, investors and analysts, helping to benchmark company performance against competitors or the sector in which the company's shares appear. However, mandating quarterly reports for all companies at EU level risks imposing additional costs on companies that don't report quarterly without producing the benefits of a "relevant disclosure" regime.

Company websites are growing in importance in developing the dialogue between companies and their investors (and potential investors). Investor relations professionals increasingly use dedicated sections of company websites to communicate with shareholders and these are valuable sources of information. But this relies on the investor "pulling" information and actively searching for it, or each investor or potential investor has to subscribe to every individual company website. There are two basic flaws in relying on this model. First, it's not always possible to know where to look. And secondly, it's hardly practical to scour thousands of websites in the hope of finding "What's New".

It's "relevant" not "regular" disclosure that is more important to the dialogue between companies and investors - i.e. "what" you report and "how" you report it.

Mandating quarterly reporting won't of itself deliver higher standards of disclosure. Relevant immediate disclosure will achieve much greater transparency than periodic disclosures, whatever the intervals between them.

Constantly monitoring thousands of individual websites for company news is practically impossible even for global investment banks let alone the individual private investor.

Our preferred system for disclosure

Because we believe that the most effective and fair way for companies to disclose regulatory news is by real-time, electronic "push" of the full text of announcements, companies must have access to services that can deliver effectively. This is best achieved at reasonable cost by providing companies with a *choice* of competing news dissemination services. If news providers are required to meet key performance standards - for example, to ensure security and timeliness of announcements, such a competitive market for providers helps to promote innovation while keeping the costs to companies down. It will also ensure that no one has a monopoly on news provision.

Such a system, with mutual recognition of news providers, offers genuine scope for a pan-European market for regulatory news services to develop. If Member States continue to rely on less effective mechanisms (with or without quarterly reporting) the overall FSAP goal of creating a genuine integrated market in financial services will be missed.

In our more detailed comments on the Directive (at Appendix 1 below) we highlight several key aspects of the way the Directive regulates news dissemination and where we think changes are necessary.

Unless the Directive mandates effective cross-border news dissemination based on mutual recognition for providers, there is no prospect of a seamless provision of information on *all* EU companies to *all* EU investors.

Economic benefits of high quality disclosure

What benefits[2] would the system we advocate bring to Europe?

- **benefits flow to investors - in terms of lower risk and increased confidence.**

Investors are clearly less likely to invest where they suspect that others enjoy advantages in terms of what they know about the company or the market in which it operates. And there is greater scope for insider dealing where information distribution is uneven. The system we advocate also avoids the cost of trying to scan thousands of potential sources of information.

- **benefits flow to companies** - **cutting the cost of capital and increasing the attractiveness of public equity markets as a source of finance.**

Better disclosure has been proven to reduce the cost to a company of raising capital[3] and lowering the cost of capital is a key objective of the Lisbon agenda. Only if Europe's companies have a cost of capital that is competitive can they be competitive globally. A constant flow of companies to Europe's equity markets is vital if they are to grow and help us deliver the greater prosperity that Europe wants and needs.

- **benefits flow to markets - reducing the scope for abuse, boosting liquidity and strengthening the share price formation process**.

If investors have greater confidence to invest and companies are attracted to list and be admitted to trading, this creates a virtuous circle of market quality, investor confidence and liquidity. Importantly, market abuse can be harder to commit and easier to detect if modern surveillance techniques are applied that link the release of company information to trading activity. An unusual pattern of trading around a major announcement can be prima facie evidence of insider dealing.

Effective electronic cross-border dissemination also removes a significant barrier to integrating EU capital markets, benefiting the wider economy .

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[2] Appendix 2: The “Economics of Information” sets out the theory behind these statements.
[3] ref Cynthia Glassman "Improving Corporate Disclosure - Improving Shareholder Value", 10 April 2003, http://www.sec.gov/news/speech/spch041003cag.htm

APPENDIX 1

Comments on News Dissemination under the EU Transparency Directive

Relevant versus regular disclosure

Notwithstanding the less onerous requirements for **quarterly reporting** now proposed in Article 6 of the Directive, we are concerned that mandating it in this way:

- shifts focus from transparent, continuous disclosure which is regarded by investors as more integral to high quality markets;
- would add unnecessary costs to companies for limited incremental benefits;
- may result in a greater focus on short-term performance rather than on the company's longer-term objectives; and
- risks undermining the regime for continuous disclosure by creating an incentive to "save-up" bad news and release it through a periodic statement.

> **The quality, reliability and timeliness of reporting are key, not its frequency.**

US – moving from regular to relevant?

Senior US officials have questioned whether **quarterly reporting** produces relevant information for investors. Former SEC Chairman Harvey Pitt said:

> "*Our disclosure system is built around the concept of "periodic disclosure". But periodic disclosure - that is, disclosure every quarter – implies that information is static, not dynamic, and that allowing companies to wait until the end of a quarter to disclose significant information is the best that we can do for investors. Our current system…does not provide nearly enough useful information to investors….By the time the information our system provides is actually available to investors, it is often stale."*[4]

> **Instead, he proposed a system of "current" disclosure, where public companies would have to disclose "unquestionably material" information as it arose, taking into consideration how modern technology can put information into investors' hands more promptly and in a user-friendly way.**

[4] Harvey Pitt, "Remarks before the AICPA Governing Council", 22 October 2001, http://www.sec.gov/news/speech/spch516.htm.

Best practice in news dissemination – reducing the scope for market abuse

It is in the interests of a publicly traded company to keep the market regularly informed of its trading position and progress and of other material matters on a timely basis and in a way that helps prevent market abuse. If price sensitive information is embargoed until release - and upon release sent simultaneously to all investors - companies and markets create certainty regarding the time of publication and enable effective monitoring and enforcement of market abuse rules.

Such mechanisms should be used not only for price sensitive news that may move the value of a company's shares but also for a wider range of regulatory disclosures, such as major shareholdings and periodic financial reports, many of which are highly relevant to an investor's evaluation of an existing or potential investment.

Best practice is by no means universal and here are considerable differences between jurisdictions in the EU. In the UK around 700 announcements are made daily (of which around 200 are "news" announcements including ad hoc price sensitive disclosure and trading updates) compared with 20 or so in Germany.

> **Real-time, electronic "push" of the full text of company announcements is effective, efficient and equitable.**
>
> **Timely and simultaneous distribution reduces the scope for market abuse.**

A model of competing news dissemination services

We believe that the benefits of real-time, electronic "push" of regulatory information are best achieved by providing companies with a choice of competing dissemination services (all operating to an appropriate standard) through which they disclose their corporate news. This helps to keep the costs to companies down and will ensure that no one has a monopoly on news provision.

In turn, these organisations simultaneously distribute the information to investors throughout Europe via real-time services such as Reuters (reaching approximately 600,000 terminals worldwide), Bloomberg, Thomson Financial and investor websites. There are also free-to-access services aimed at retail investors such as hemscott and ADVFN.

> **The principal advantages of a competitive approach are:**
>
> - **easy to use systems which, through innovation, constantly develop;**
> - **removal of information asymmetries that disproportionately adversely affect retail investors;**
> - **cross-border participation by investors is encouraged.**

Home versus host regulation

Article 17 of the proposed Directive obliges *home* Member States to ensure that issuers disseminate both periodic and ad hoc regulatory information in a timely manner throughout their territory and abroad. But when Member States are acting in a *host* capacity to non-domestic issuers, regulators may not impose any rules over which media can be used and may only require issuers to publish information on their own websites.

> **Our concern is that in its current form Article 17 will:**
>
> - **lead to a fragmented system of national dissemination mechanisms;**
> - **place onerous requirements on some issuers;**
> - **inhibit cross-border investment, a vital ingredient of a single market.**

Company websites

Company websites can provide a useful source of information for investors, and the posting of financial results and other shareholder communications is developing as best practice for companies' own investor relations programmes.

However, as the sole or primary means of disseminating key regulatory information, company websites have considerable limitations, most significantly:

- the cost and impracticality of constantly trying to monitor many websites[5] on an ongoing basis – putting this out of reach of the private investor;
- no contextual news is provided for example on the industry sector;
- potential "disorderliness" created in the market in a company's securities as information disseminates gradually into the market, allowing those who see it first to trade at an advantage to everyone else; and
- the danger that less favourable news could be placed in less accessible parts of a company's website – a real danger when companies' websites are becoming increasingly complex, covering an ever growing proportion of activities.

> **While company websites are an increasingly powerful tool in investor relations they cannot be the primary mechanism for news distribution to the wider market.**

[5] There are around 8,000 publicly quoted companies in the EU. Even the largest global investment bank couldn't keep watch on every company's website, let alone the private investor.

Newspapers

We are not seeking to end the current practice of making some announcements in regulatory newspapers as a matter of record. We believe that for some "static" regulatory announcements, for example of the date and time of an AGM, newspaper distribution is appropriate and newspapers continue to provide a useful additional voluntary means of communication for companies. But it is simply not possible to ensure simultaneous, timely and cross-border disclosure of priority regulatory news via printed newspaper reports.

Against the background of significant advances in electronic, real-time news distribution mechanisms, the use of printed newspapers as a primary means of disseminating regulatory information is no longer appropriate, and provides otherwise avoidable opportunities for market abuse.

Conclusions

Establishing the principle of effective electronic information dissemination for ongoing regulatory disclosure in the Transparency Directive will ensure that regulatory information is distributed quickly, simultaneously and widely to all market participants and investors and thereby:

- **protect all investors – particularly private investors - by ensuring a 'level playing field';**
- **reduce the scope for market abuse;**
- **encourage cross-border share trading; and**
- **harmonise access across the EU to company information.**

APPENDIX 2

The "Economics of Information"

Background

Classic economic theory believed that market participants possessed "perfect" information. In 2001, three economists, Akerlof, Stiglitz and Spence were awarded the Nobel Prize in Economics for challenging this assumption.

Their work (which began in the 1970s) looked at the economics of asymmetric information and the associated problems of adverse selection. They concluded that when different market participants possess different information, sub-optimal market outcomes occur which in time could threaten the market itself.

Overview

There is a sizeable amount of literature on how increased disclosure of company information to the market benefits investors, the company and the market.

Increased disclosure lowers a company's cost of capital

Easley and O'Hara, 2001[6] develop an asset-pricing model that demonstrates that information disclosure affects a firm's cost of capital.

They argue that investors demand a higher return to hold stocks with greater private (i.e. non-publicly disseminated) information. The higher return reflects the fact that private information increases the risk to uninformed investors of holding the stock because informed investors are better able to shift their portfolio weights to incorporate new information.

Increased disclosure leads to increased liquidity

Frost, Gordon and Hayes, 2002[7], studied associations between measures of stock exchange disclosure and market liquidity at the 50 member stock exchanges of the WFE. They found that the strength of disclosure system is positively associated with market liquidity after controlling for stock exchange size, legal system and several other proxies for the extent of market development and the information environment.

Increased disclosure benefits investors

> **Frost, Gordon and Hayes also state that:**
> **"Timely and credible company disclosure should promote investor confidence, which should encourage investors to participate more actively in the market. As a result, market activity will increase, and capital formation will be facilitated."**

[6] Easley, D. and M. O'Hara, "Information and the Cost of Capital"
[7] Frost, C.A., E.A. Gordon and A.F. Hayes. "Stock Exchange Disclosure and Market Liquidity: An Analysis of 50 international Exchanges" Extension of a research project for the World Federation of Exchanges, 2002.